Supreme Court, U.S.
FILED
MAR 15 2002
OFFICE OF THE CLERK

(3)

No. 01-1030

IN THE

Supreme Court of the United States

WINN-DIXIE STORES, INC., AND SUBSIDIARIES,
PETITIONERS,

V.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

BRIEF OF *AMICI CURIAE* COX ENTERPRISES, INC. AND MEDIA GENERAL, INC. IN SUPPORT OF PETITIONERS

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INTERESTS OF *AMICI CURIAE*[1]

Cox Enterprises, Inc. and Media General, Inc. (collectively, "*amici*") own and are beneficiaries of insurance policies on the lives of employees and are interested in having the decision in this case reversed. Also, *amici* are interested in this Court granting the Petition for Writ of Certiorari because the current disarray, confusion, and conflict among the circuits regarding the sham transaction doctrine have generated great uncertainty in the administration of the tax laws, which can be resolved only by this Court.

Cox Enterprises, Inc. ("Cox"), which owns television stations, cable systems, newspapers, radio stations, automobile auctions, and interactive media businesses, is a large employer headquartered in Atlanta, Georgia. Cox Communications, Inc., a publicly held Cox subsidiary, is the country's fifth largest cable company, and Manheim Auctions, Inc., a Cox subsidiary, is the largest automobile auction company in the world. Among its media and other businesses, Cox publishes the *Atlanta Journal-Constitution*.

Media General, Inc. ("Media General"), which is a publicly held communications company headquartered in Richmond, Virginia, also is a large employer. Media General owns and operates 25 daily newspapers, nearly 100 periodicals, 26 network-affiliated television stations reaching approximately 8% of U.S. households, over 50 interactive media businesses, and diversified information services.

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[1] Letters evidencing the consent of the parties to the filing of this brief have been submitted. Pursuant to Supreme Court Rule 37.6, *amici* state that no counsel for a party has authored this brief in whole or in part and that no person or entity, other than *amici*, their members or their counsel, has made any monetary contribution to the preparation or submission of this brief.

REASONS FOR GRANTING THE WRIT

This case presents an ideal vehicle for the Court to provide needed clarity, consistency, and predictability regarding the proper interpretation and application of the sham transaction doctrine in order to enable taxpayers to plan their financial activities. Created by the Court in *Gregory v. Helvering*, 293 U.S. 465 (1935), and *Knetsch v. United States*, 364 U.S. 361 (1960), the sham transaction doctrine has become a matter of great concern for taxpayers as a result of aggressive efforts by the Internal Revenue Service ("IRS") to apply this doctrine across the spectrum of federal tax law to virtually every type of taxpayer and form of financial transaction.[2] The implications of this case, therefore, extend beyond debt-financed life insurance to virtually all business transactions.

As applied by the Eleventh Circuit, the sham transaction doctrine is an extra-statutory requirement, overlaying the

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[2] *See, e.g., Frank Lyon Co. v. United States*, 435 U.S. 561 (1978) (corporation); *Knetsch*, 364 U.S. 361 (individual); *ACM P'ship v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999) (partnership); *Duke Energy Corp. v. United States*, 49 F. Supp. 2d 837 (W.D.N.C. 1999) (income tax); *Estate of Church v. United States*, 85 A.F.T.R.2d 2000-804, 2000 WL 206374 (W.D. Tex. 2000) (estate and gift tax); *Jeffery B. Fleck Co., L.P.A. v. United States*, 86 A.F.T.R.2d 2000-5749, 2000 WL 1274241 (N.D. Ohio 2000) (payroll tax). Indeed, the IRS claims the sham transaction doctrine applies to nearly any transaction in which the anticipated pre-tax profit is not significant in relation to the anticipated tax benefits. *See, e.g.*, Rev. Rul. 99-14, 1999-1 C.B. 835. Corporate transactions challenged by the IRS generally include the following: (i) transactions generating losses, deductions, or credits, such as *ACM*, *supra* (capital losses), *Compaq Computer Corp. v. Commissioner*, No. 00-60648, 2001 WL 1662035 (5th Cir. Dec. 28, 2001) (foreign tax credits), and *UPS v. Commissioner*, 254 F.3d 1014 (11th cir. 2001) (deductions); (ii) transactions generating economically accrued losses, such as *Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554 (1991) (mortgage portfolios); (iii) tax-driven corporate financings, such as *Frank Lyon*, *supra* (sale and leaseback of office building); or (iv) transactions designed to minimize gain on the sale or disposition of corporate assets, *i.e.*, through tax-free incorporations or reorganizations, such as *Gregory*, *supra*.

Internal Revenue Code ("Code"),[3] which requires a "likely pre-tax profit" as a precondition to consideration of statutory compliance. The doctrine is thus available to be invoked whenever the IRS dislikes the tax outcome that would result from applying the law as written. This case provides the perfect vehicle for the Court to intervene and provide guidance because the significant features of the sham transaction doctrine are present.

I. THE COURT'S INTERVENTION IS NEEDED TO RESOLVE THE CONFUSION AND DISARRAY AMONG LOWER COURTS IN APPLYING THE SHAM TRANSACTION DOCTRINE.

Petitioners demonstrate convincingly that lower courts have taken conflicting approaches in applying the "sham transaction" doctrine. Furthermore, as a consequence of these conflicts, the sham transaction doctrine has become a standardless and arbitrary morass, an intolerable state of affairs that requires the Court's intervention.

Some courts, including the Third and Eleventh Circuits, have held that any transaction determined to be a sham cannot be recognized for tax purposes, irrespective of the applicable Code provision. *See, e.g., Lerman v. Commissioner*, 939 F.2d 44 (3d Cir. 1991); *Kirchman v. Commissioner*, 862 F.2d 1486, 1491 (11th Cir. 1989). On the other hand, the D.C. Circuit in *Horn v. Commissioner*, 968 F.2d 1229 (D.C. Cir. 1992), held that the "sham transaction doctrine [is] merely [a] judicial device[] for divining and effectuating congressional intent, not for supplanting it." *Id.* at 1234.

There is a separate and additional conflict regarding the "business purpose" test that is part of sham analysis. The

[3] Unless indicated otherwise, all references to the "Code" and the "I.R.C." are to the Internal Revenue Code of 1993. The Appendix reproduces the provisions of Code sections referred to herein.

Eleventh Circuit, for example, held in this case that a transaction lacking a business purpose, *ipso facto*, is not recognized for tax purposes (Pet. App. 5a);[4] the Second, Fourth, and D.C. Circuits have held that a transaction with economic substance but lacking a business purpose, *ipso facto*, is not a sham;[5] and the Third, Sixth, Ninth, and Tenth Circuits have undertaken a holistic inquiry into the substance and purpose of the transaction.[6] Furthermore, taxpayer confusion is not limited to the relative weight of "business purpose" in the sham analysis, but also depends on how a court defines a valid business purpose. For example, the Eleventh Circuit has held that the "business purpose" inquiry is based on a "subjective analysis of the taxpayer's intent," *Kirchman*, 862 F.2d at 1492, while this Court and some lower courts have held that motive and intent should be disregarded. *See, e.g., Gregory*, 293 U.S. at 469; *Yosha v. Commissioner*, 861 F.2d 494, 501-02 (7th Cir. 1988).

Finally, and most importantly, there is not only a conflict among lower courts as to the appropriateness of a pre-tax profit test but also a conflict, among the lower courts that utilize a pre-tax profit test, as to the standard by which economic substance is to be calculated – specifically, whether a "pre-tax profit" is required in all circumstances and, if so, how it is to be determined. As applied by some circuits, the "pre-tax profit" test is an arbitrary, mechanical test, with no statutory basis. In those circuits, in order for a transaction to have economic substance, there must be a sufficient

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[4] "Pet. App." refers to the Appendix to the Petition.

[5] *See DeMartino v. Commissioner*, 862 F.2d 400, 406 (2d Cir. 1988); *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 91-92 (4th Cir. 1985); *Horn*, 968 F.2d at 1237.

[6] *See ACM*, 157 F.3d at 248-50 (3d Cir.); *Rose v. Commissioner*, 868 F.2d 851, 853 (6th Cir. 1989); *Sochin v. Commissioner*, 843 F.2d 351, 354 (9th Cir.), *cert. denied*, 488 U.S. 824 (1988); *James v. Commissioner*, 899 F.2d 905, 908-09 (10th Cir. 1990).

likelihood[7] of a sufficient amount[8] of pre-tax profit, calculated at a particular time[9] for a particular portion[10] of the transaction and based on a particular method[11] of calculating "pre-tax."

The arbitrariness of this approach is patent because altering any one of the constituent variables can mean the difference between a "legitimate" transaction and a "sham." *See, e.g., Compaq, supra* (pre-tax profit existed because circuit court rejected lower court's method of calculating "pre-tax profit"

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[7] Courts have adopted a range of standards regarding the required probability of a pre-tax profit. *See, e.g., Rice's Toyota,* 752 F.2d at 91 (reasonable possibility); *ACM,* 157 F.3d at 244, 257 ("reasonably expected"); *Winn-Dixie Stores, Inc. v. Commissioner,* 113 T.C. 254, 285 (1999), *aff'd per curiam,* 254 F.3d 1313 (11th Cir. 2001) ("likely"). Some courts, such as the Sixth Circuit, have held that a "reasonable possibility" standard is inapplicable to bona fide transactions with a remote possibility of a large profit, such as wildcat oil exploration. *See, e.g., Bryant v. Commissioner,* 928 F.2d 745, 749 (6th Cir. 1991).

[8] The amount of pre-tax profit necessary for a transaction to be recognized for tax purposes varies widely among the courts. *See, e.g., Boca Investerings P'ship v. United States,* 167 F. Supp. 2d 298, 358 (D.D.C. 2001) (any profit sufficient with no discounting for present value required); *Estate of Thomas v. Commissioner,* 84 T.C. 412, 440 n.52 (1985) (*de minimis* profit sufficient); *Sheldon v. Commissioner,* 94 T.C. 738, 767 (1990) (*de minimis* profit insufficient); *Hilton v. Commissioner,* 74 T.C. 305, 370 (1980), *aff'd per curiam,* 671 F.3d 316 (9th Cir. 1982) (pre-tax profit required on a present value basis at a discount rate of 6%); *ACM,* 157 F.3d at 258 ($5.4 million pre-tax profit with a 4.7% internal rate of return a "nominal, incidental pre-tax profit"); *Hines v. United States,* 912 F.2d 736, 739 (4th Cir. 1990) (reasonable pre-tax profit required in relation to anticipated tax benefits).

[9] *Compare Rice's Toyota, supra* (pre-tax profit calculated based on taxpayer's projections at time of purchase), *with Compaq, supra,* (pre-tax profit calculated based on actual pre-tax profit).

[10] *See, e.g., ACM,* 157 F.3d at 262 (applying pre-tax profit test to "separable, economically substantive items" distinct from sham aspects, so long as they are not "the centerpiece of the whole scheme").

[11] *See, e.g., Compaq, supra* (lower court and circuit court applied different methods of calculating "pre-tax profit"); *IES Indus., Inc. v. United States,* 253 F.3d 350 (8th Cir. 2001) (same).

and on that basis reversed lower court's sham determination); *IES, supra* (same). For this reason, the Ninth Circuit specifically rejected the pre-tax profit test in *Sacks v. Commissioner*, 69 F.3d 982, 991 (9th Cir. 1995). *See also Jacobson v. Commissioner*, 915 F.2d 832, 838 (2d Cir. 1990) (refusing to apply the pre-tax profit test and thereby establish a "dangerous precedent"). Not only is the pre-tax profit test arbitrary, but it also lacks any economic principle to support it. For example, efficient capital markets will drive the pre-tax yield of certain tax-favored transactions below zero,[12] and pre-tax profit can easily be created in any transaction simply by adding equity, *i.e.*, borrowing less.[13] Because this so-called "objective" test is so arbitrary and is in derogation of fundamental principles of economics, the sham transaction doctrine has become an unpredictable, subjective "smell" test. *ACM*, 157 F.3d at 265 (McKee, J., dissenting).

II. RECURRING QUESTIONS OF STATUTORY CONSTRUCTION RAISED BY THE SHAM ANALYSIS ESTABLISH THE NEED FOR THE COURT'S GUIDANCE.

The Court's intervention is imperative both to resolve the inconsistent and arbitrary applications of the sham transaction doctrine among the lower courts and to address the source of that inconsistency: the disregard for established principles of statutory construction. Under clear precedents of the Court, the sham transaction doctrine is a principle of statutory construction. However, as the doctrine has evolved, several lower courts have transformed it into an extra-statutory threshold test. Due to the overarching nature of the doctrine in the administration of tax laws and its broad implications for

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[12] *See, e.g.*, Joseph Bankman, *The Economic Substance Doctrine*, 74 S. Cal L. Rev. 5, 24 (2000).

[13] *See, e.g.*, David P. Hariton, *The Compaq Case, Notice 98-5, and Tax Shelters: The Theory is All Wrong*, 94 Tax Notes 501, 509 (Jan. 28, 2002).

statutory construction generally, guidance from the Court is essential.

A. The Court Has Consistently Refused To Violate The Plain Meaning Of A Tax Statute To Deny A Tax Benefit.

In several tax cases not involving sham transactions, the Court has declined to violate the plain meaning of the Code even to close an acknowledged tax loophole and, in so doing, has rejected the Government's assertion that a taxpayer complying with the Code should not be allowed to claim tax benefits on the ground that those benefits could not have been intended by Congress. For example, in *Hanover Bank v. Commissioner*, 369 U.S. 672 (1962), this Court relied on the "plain and ordinary language" of the Code provision at issue, *id.* at 687, and rejected the Government's assertion that "the statute has created a tax loophole of major dimension that should be closed short of allowing the deduction sought in this case." *Id.* at 682. The Court held that "[w]hile this assertion might have been persuasive in securing enactment of the amendments to the statute made subsequent to the time the transactions took place, . . . it may not, of course, have any impact upon our interpretation of the statute under review." *Id.* Likewise, in *Gitlitz v. Commissioner*, 531 U.S. 206, 219-20 (2001), the Court held that addressing the Government's policy concerns regarding the existence of a tax loophole was unnecessary "[b]ecause the Code's plain

text permits ... [the tax] benefits."[14] This principle of statutory construction applies with even greater force when highly specific provisions are involved, as here with Code Section 264.[15]

In *Gregory*, the Court clearly established that sham analysis begins with the language of the statute[16] and then focuses on "whether what was done, apart from the tax motive, was the thing which the statute intended." 293 U.S. at 469. In other words, a sham is simply a transaction that "in reality was [not] effected within the meaning of [the statute]." *Id.* In *Knetsch*, for example, the Court examined "indebtedness" as used in Code Section 163 under the "plain meaning" standard and concluded that the loan transactions at issue were a "fiction" and did not constitute "indebtedness." 364 U.S. at

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[14] *See also Commissioner v. Brown*, 380 U.S. 563, 579 (1965) ("We ... deem it wise to leave to the Congress the fashioning of a rule which, in any event, must have wide ramifications.") (quotations and citations omitted); *Am. Auto. Ass'n v. United States*, 367 U.S. 687, 697 (1961) ("The validity of the long-established policy of the Court in deferring, where possible, to congressional procedures in the tax field is clearly indicated [by the plain meaning of the statute] in this case."); *The Thomas Barlum v. Barlum S.S. Co.*, 293 U.S. 21, 38 (1934) (refusing to imply an extratextual remedy to close a tax loophole).

[15] *See, e.g., Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432, 447 (1999) ("because ERISA is a comprehensive and reticulated statute, and is enormously complex and detailed, it should not be supplemented by extratextual remedies") (quotations and citations omitted); *Huntsberry v. Commissioner*, 83 T.C. 742, 747-48 (1984) ("[W]here a [tax] statute is clear on its face, we ... require unequivocal evidence of legislative purpose before construing the statute so as to override the plain meaning of the words ... [a]nd this is particularly so ... where we have a complex set of statutory provisions marked by a high degree of specificity.").

[16] In this respect, the sham inquiry utilizes the same principles that guide this Court in the construction of non-tax statutes. *See, e.g., INS v. Phinpathya*, 464 U.S. 183, 189 (1984) ("This Court has noted on numerous occasions that in all cases involving statutory construction, our starting point must be the language employed by Congress, ... and we assume that the legislative purpose is expressed by the ordinary meaning of the words used.") (quotations and citations omitted).

366. In contrast, the policy loans upon which interest was paid in this case were found to have "actually occurred" (Pet. App. 41a) and constituted "an enforceable debt." (Pet. App. 42a.)

Finally, the Court recently recognized that the plain meaning of a statute cannot be circumvented merely by arguing that the transaction "amounted to a sham transaction." *Hughes Aircraft Co.*, 525 U.S. at 445. Nevertheless, by applying an extra-statutory sham analysis, several lower courts have done precisely that.

B. The Sham Analysis Of Some Lower Courts Circumvents The Meaning Of Tax Statutes.

The Court's sham analysis is based on an examination of the appropriate "form" and intended "substance" of a transaction when measured against a particular tax statute. However, some courts, such as the Third and Eleventh Circuits, apply extra-statutory tests, such as the pre-tax profit test, to determine whether a transaction is a sham. *See, e.g.*, *Lerman*, 939 F.2d at 52 ("economic substance is a *prerequisite* to the application of any Code provisions allowing deductions"); *Kirchman*, 862 F.2d at 1491 (same). As one commentator explains, this practice represents a shift from statutory construction to judicial legislation:

> When someone calls a dog a cow and then seeks a subsidy provided by statute for cows, the obvious response is that this is not what the statute means. It may also happen that rich people who would not otherwise have cows buy them to gain cow subsidies. Here, when people say (as they do) that this is not what the statute means, they are in fact saying something quite different.

Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. Chi. L. Rev. 859, 865 (1982). *See also* John F. Coverdale, *Text as Limit: A Plea for a Decent Respect for*

the Tax Code, 71 Tul. L. Rev. 1501, 1506 (1997) (similar example).

Extra-statutory sham standards, most notably the "pre-tax profit test," provide extensive opportunities for mischief. To the IRS or a court that does not like the results of applying the statute as written, it is simply irrelevant that whenever Congress requires a profit, it has unequivocally so provided in the Code. In fact, profit requirements in the Code,[17] many of which are virtually identical to the pre-tax profit test promulgated by some courts, specifically address the requisite amount of pre-tax profit and the relevant factors that should be taken into account. Where there is no profit requirement, it is not the job of the courts to create one.[18]

Like the pre-tax profit test, the extra-statutory "business purpose" test also allows courts to circumvent tax statutes by creating a requirement for a "business purpose" that does not appear in the Code provision at issue. This conflicts with decisions such as *United Dominion Industries, Inc. v. United States*, 121 S. Ct. 1934, 1942 (2001), in which the Court refused to imply a business purpose requirement in a Treasury regulation when Code Section 269 already addressed the tax-

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[17] *See, e.g.*, I.R.C. § 165(c)(2) (loss deduction safe harbor for individuals for "losses incurred in any transaction entered into for profit"); I.R.C. § 183(a) (no deduction allowed for individuals and S corporations if an expense arises out of an activity that is not engaged in for profit); I.R.C. § 195(c)(1)(A)(iii) (in definition of "start-up expenditure," distinction between active trade or business, on the one hand, and activity engaged in for profit and for the production of income in anticipation of becoming an active trade or business); I.R.C. § 212 (deduction allowed for ordinary and necessary expenses incurred in transactions for the production of income); I.R.C. § 263A(c)(1) (capitalization of certain costs incurred in an activity conducted for profit).

[18] *See, e.g.*, *Int'l Trading Co. v. Commissioner*, 484 F.2d 707, 711, 713 (7th Cir. 1973) (Court held that there is no business purpose or profit requirement for loss deductions under Code Section 165(a) because there is "no basis . . . to put words into the statute that, whatever the reasons may have been, Congress did not put there. Our task is to construe and apply, not to write, legislation.").

motivated behavior involved in the transaction. Code Section 269 provides the IRS authority to "disallow [any] deduction, credit, or other allowance" that results from certain acquisitions of stock and assets "the principal purpose [of] which . . . is evasion or avoidance of Federal income tax." There are several similar business purpose provisions in the Code.[19] In contrast, where there is no statutory business purpose requirement, the taxpayer's motivation is simply irrelevant. *See, e.g., Arkansas Best Corp. v. Commissioner*, 485 U.S. 212, 223 (1988) (holding that "a taxpayer's motivation in purchasing an asset is irrelevant" where the Code provision at issue does not require any inquiry into motivation).

As the Court recently noted in *Gitlitz*, 531 U.S. at 219-20, the role of the courts is to interpret the meaning of the Code, rather than modify it judicially in order to close or create tax loopholes. However, as exemplified in the case below, a number of lower courts, emboldened by the increasingly expansive application of the sham transaction doctrine to all manner of transactions and types of taxpayers, have used it either to circumvent the relevant Code provisions or to erect extra-statutory barriers against tax benefits specifically granted by Congress. The uncertainty that results is so great that it constitutes a trap for the unwary. Accordingly, it is imperative for the Court to provide guidance to the lower

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[19] *See, e.g.*, I.R.C. § 357(b)(1) (requiring determination of whether certain debt transfers to controlled corporations had a "principal purpose" of tax avoidance); I.R.C. § 482 (providing IRS with broad authority to reallocate income, deductions, credits or allowances between related parties to prevent tax evasion and to clearly reflect income); I.R.C. § 532 (special tax on "every corporation . . . formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed"); I.R.C. § 845(b) (providing IRS authority to make proper adjustments with respect to any party to a reinsurance contract to eliminate a "significant tax avoidance effect").

courts regarding this significant issue of statutory construction.

III. THIS IS AN APPROPRIATE CASE FOR THE COURT TO RESOLVE THE CONFLICTS CREATED BY THE CIRCUIT COURTS.

This case implicates the major elements of the substantive sham doctrine about which the lower courts are in conflict. As Petitioners cogently demonstrate, this case arises in the context of a tax-preferred transaction with respect to which Congress has legislated frequently and with great specificity. This case also involves a transaction that has been demonized for tax purposes on the ground that it was tax-motivated and without business purpose. It is hard to imagine a more appropriate opportunity for the Court to clear up the confusion and inconsistencies created by the welter of conflicting decisions regarding the sham transaction doctrine.

The Government cannot be heard to suggest in response that this case is not significant because prospective conflicts have been precluded by congressional action in amending Code Section 264. The myriad cases cited herein demonstrate that the issues surrounding the sham transaction doctrine pervade the tax law, affecting a broad range of transactions and industries, and that the application of the doctrine continues both to evolve and to expand. This case presents an excellent opportunity for the Court to resolve the numerous issues subsumed within this talismanic concept.

CONCLUSION

For the foregoing reasons, *amici* endorse the arguments made by Petitioners and urge this Court to grant the Petition for a Writ of Certiorari.

Respectfully submitted,

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March 15, 2002

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STATUTORY PROVISIONS

I.R.C. § 163 (1993)

§ 163. Interest.

(a) General rule. There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

(b) Installment purchases where interest charge is not separately stated.

(1) General rule. If personal property or educational services are purchased under a contract--

(A) which provides that payment of part or all of the purchase price is to be made in installments, and

(B) in which carrying charges are separately stated but the interest charge cannot be ascertained, then the payments made during the taxable year under the contract shall be treated for purposes of this section as if they included interest equal to 6 percent of the average unpaid balance under the contract during the taxable year. For purposes of the preceding sentence, the average unpaid balance is the sum of the unpaid balance outstanding on the first day of each month beginning during the taxable year, divided by 12. For purposes of this paragraph, the term "educational services" means any service (including lodging) which is purchased from an educational organization described in section 170(b)(1)(A)(ii) and which is provided for a student of such organization.

(2) Limitation. In the case of any contract to which paragraph (1) applies, the amount treated as interest for any

taxable year shall not exceed the aggregate carrying charges which are properly attributable to such taxable year.

(c) Redeemable ground rents. For purposes of this subtitle, any annual or periodic rental under a redeemable ground rent (excluding amounts in redemption thereof) shall be treated as interest on an indebtedness secured by a mortgage.

(d) Limitation on investment interest.

(1) In general. In the case of a taxpayer other than a corporation, the amount allowed as a deduction under this chapter for investment interest for any taxable year shall not exceed the net investment income of the taxpayer for the taxable year.

(2) Carryforward of disallowed interest. The amount not allowed as a deduction for any taxable year by reason of paragraph (1) shall be treated as investment interest paid or accrued by the taxpayer in the succeeding taxable year.

(3) Investment interest. For purposes of this subsection-

(A) In general. The term "investment interest" means any interest allowable as a deduction under this chapter (determined without regard to paragraph (1)) which is paid or accrued on indebtedness properly allocable to property held for investment.

(B) Exceptions. The term "investment interest" shall not include--

(i) any qualified residence interest (as defined in subsection (h)(3)), or

(ii) any interest which is taken into account under section 469 in computing income or loss from a passive activity of the taxpayer.

(C) Personal property used in short sale. For purposes of this paragraph, the term "interest" includes any amount allowable as a deduction in connection with personal property used in a short sale.

(4) Net investment income. For purposes of this subsection--

(A) In general. The term "net investment income" means the excess of--

(i) investment income, over

(ii) investment expenses.

(B) Investment income. The term "investment income" means the sum of--

(i) gross income from property held for investment (other than any gain taken into account under clause (ii)(I)),

(ii) the excess (if any) of--

(I) the net gain attributable to the disposition of property held for investment, over

(II) the net capital gain determined by only taking into account gains and losses from dispositions of property held for investment, plus

(iii) so much of the net capital gain referred to in clause (ii)(II) (or, if lesser, the net gain referred to in clause (ii)(I)) as the tax payer elects to take into account under this clause.

(C) Investment expenses. The term "investment expenses" means the deductions allowed under this chapter

(other than for interest) which are directly connected with the production of investment income.

(D) Income and expenses from passive activities. Investment income and investment expenses shall not include any income or expenses taken into account under section 469 in computing income or loss from a passive activity.

(E) Reduction in investment income during phase-in of passive loss rules. Investment income of the taxpayer for any taxable year shall be reduced by the amount of the passive activity loss to which section 469(a) does not apply for such taxable year by reason of section 469(m). The preceding sentence shall not apply to any portion of such passive activity loss which is attributable to a rental real estate activity with respect to which the taxpayer actively participates (within the meaning of section 469(i)(6)) during such taxable year.

(5) Property held for investment. For purposes of this subsection--

(A) In general. The term "property held for investment" shall include--

(i) any property which produces income of a type described in section 469(e)(1), and

(ii) any interest held by a taxpayer in an activity involving the conduct of a trade or business--

(I) which is not a passive activity, and

(II) with respect to which the taxpayer does not materially participate.

(B) Investment expenses. In the case of property described in subparagraph (A)(i), expenses shall be allocated to such property in the same manner as under section 469.

(C) Terms. For purposes of this paragraph, the terms "activity", "passive activity", and "materially participate" have the meanings given such terms by section 469.

(6) Phase-in of disallowance. In the case of any taxable year beginning in calendar years 1987 through 1990--

(A) In general. The amount of interest paid or accrued during any such taxable year which is disallowed under this subsection shall not exceed the sum of

(i) the amount which would be disallowed under this subsection if

(I) paragraph (1) were applied by substituting "the sum of the ceiling amount and the net investment income" for "the net investment income", and

(II) paragraphs (4)(E) and (5)(A)(ii) did not apply, and

(ii) the applicable percentage of the excess of

(I) the amount which (without regard to this paragraph) is not allowable as a deduction under this subsection for the taxable year, over

(II) the amount described in clause (i).

The preceding sentence shall not apply to any interest treated as paid or accrued during the taxable year under paragraph (2).

(B) Applicable Percentage. For purposes of this paragraph, the applicable percentage shall be determined in accordance with the following table:

In the case of taxable years beginning in:	The applicable percentage is:
1987	35
1988	60
1989	80
1990	90

(C) Ceiling amount. For purposes of this paragraph, the term "ceiling amount" means--

(i) $10,000 in the case of a taxpayer not described in clause (ii) or (iii),

(ii) $5,000 in the case of a marriage individual filing a separate return, and

(iii) zero in the case of a trust.

(e) Original issue discount.

(1) In general. In the case of any debt instrument issued after July 1, 1982, the portion of the original issue discount with respect to such debt instrument which is allowable as a deduction to the issuer for any taxable year shall be equal to the aggregate daily portions of the original issue discount for days during such taxable year.

(2) Definitions and special rules. For purposes of this subsection--

(A) Debt instrument. The term "debt instrument" has the meaning given such term by section 1275(a)(1).

(B) Daily portions. The daily portion of the original issue discount for any day shall be determined under section

1272(a) (without regard to paragraph (7) thereof and without regard to section 1273(a)(3)).

(C) Short-term obligations. In the case of an obligor of a short-term obligation (as defined in section 1283(a)(l)(A)) who uses the cash receipts and disbursements method of accounting, the original issue discount (and any other interest payable) on such obligation shall be deductible only when paid.

(3) Special rule for original issue discount on obligation held by related foreign person.

(A) In general. If any debt instrument having original issue discount is held by a related foreign person, any portion of such original issue discount shall not be allowable as a deduction to the issuer until paid. The preceding sentence shall not apply to the extent that the original issue discount is effectively connected with the conduct by such foreign related person of a trade or business within the United States unless such original issue discount is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a treaty obligation of the United States.

(B) Related foreign person. For purposes of subparagraph (A), the term "related foreign person" means any person--

(i) who is not a United States person, and

(ii) who is related (within the meaning of section 267(b)) to the issuer.

(4) Exceptions. This subsection shall not apply to any debt instrument described in--

(A) subparagraph (D) of section 1272(a)(2) (relating to obligations issued by natural persons before March 2, 1984), and

(B) subparagraph (E) of section 1272(a)(2) (relating to loans between natural persons).

(5) Special rules for original issue discount on certain high yield obligations.

(A) In general. In the case of an applicable high yield discount obligation issued by a corporation--

(i) no deduction shall be allowed under this chapter for the disqualified portion of the original issue discount on such obligation, and

(ii) the remainder of such original issue discount shall not be allowable as a deduction until paid.

For purposes of this paragraph, rules similar to the rules of subsection (i)(3)(B) shall apply in determining the amount of the original issue discount and when the original issue discount is paid.

(B) Disqualified portion treated as stock distribution for purposes of dividend received deduction.

(i) In general. Solely for purposes of sections 243, 245, 246, and 246A, the dividend equivalent portion of any amount includible in gross income of a corporation under section 1272(a) in respect of an applicable high yield discount obligation shall be treated as a dividend received by such corporation from the corporation issuing such obligation.

(ii) Dividend equivalent portion. For purposes of clause (i), the dividend equivalent portion of any amount includible in gross income under section 1272(a) in respect of

an applicable high yield discount obligation is the portion of the amount so includible--

(I) which is attributable to the disqualified portion of the original issue discount on such obligation, and

(II) which would have been treated as a dividend if it had been a distribution made by the issuing corporation with respect to stock in such corporation.

(C) Disqualified portion.

(i) In general. For purposes of this paragraph, the disqualified portion of the original issue discount on any applicable high yield discount obligation is the lesser of--

(I) the amount of such original issue discount, or

(II) the portion of the total return on such obligation which bears the same ratio to such total return as the disqualified yield on such obligation bears to the yield to maturity on such obligation.

(ii) Definitions. For purposes of clause (i), the term "disqualified yield" means the excess of the yield to maturity on the obligation over the sum referred to subsection (i)(1)(B) plus 1 percentage point, and the term "total return" is the amount which would have been the original issue discount on the obligation if interest described in the parenthetical in section 1273(a)(2) were included in the stated redemption price at maturity.

(D) Exception for S corporations. This paragraph shall not apply to any obligation issued by any corporation for any period for which such corporation is an S corporation.

(E) Effect on earnings and profits. This paragraph shall not apply for purposes of determining earnings and

profits; except that, for purposes of determining the dividend equivalent portion of any amount includible in gross income under section 1272(a) in respect of an applicable high yield discount obligation, no reduction shall be made for any amount attributable to the disqualified portion of any original issue discount on such obligation.

(F) Cross reference. For definition of applicable high yield discount obligation, see subsection (i).

(6) Cross references. For provision relating to deduction of original issue discount on tax-exempt obligation, see section 1288.

For special rules in the case of the borrower under certain loans for personal use, see section 1275(b).

(f) Denial of deduction for interest on certain obligations not in registered form.

(1) In general. Nothing in subsection (a) or in any other provision of law shall be construed to provide a deduction for interest on any registration-required obligation unless such obligation is in registered form.

(2) Registration-required obligation. For purposes of this section--

(A) In general. The term "registration-required obligation" means any obligation (including any obligation issued by a governmental entity) other than an obligation which--

(i) is issued by a natural person,

(ii) is not of a type offered to the public,

(iii) has a maturity (at issue) of not more than 1 year, or

(iv) is described in subparagraph (B).

(B) Certain obligations not included. An obligation is described in this subparagraph if--

(i) there are arrangements reasonably designed to ensure that such obligation will be sold (or resold in connection with the original issue) only to a person who is not a United States person, and

(ii) in the case of an obligation not in registered form--

(I) interest on such obligation is payable only outside the United States and its possessions, and

(II) on the face of such obligation there is a statement that any United States person who holds such obligation will be subject to limitations under the United States income tax laws.

(C) Authority to include other obligations. Clauses (ii) and (iii) of subparagraph (A), and subparagraph (B), shall not apply to any obligation if--

(i) in the case of--

(I) subparagraph (A), such obligation is of a type which the Secretary has determined by regulations to be used frequently in avoiding Federal taxes, or

(II) subparagraph (B), such obligation is of a type specified by the Secretary in regulations, and

(ii) such obligation is issued after the date on which the regulations referred to in clause (i) take effect.

(3) Book entries permitted, etc. For purposes of this subsection, rules similar to the rules of section 149(a)(3) shall apply.

(g) Reduction of deduction where section 25 credit taken. The amount of the deduction under this section for interest paid or accrued during any taxable year on indebtedness with respect to which a mortgage credit certificate has been issued under section 25 shall be reduced by the amount of the credit allowable with respect to such interest under section 25 (determined without regard to section 26).

(h) Disallowance of deduction for personal interest.

(1) In general. In the case of a taxpayer other than a corporation, no deduction shall be allowed under this chapter for personal interest paid or accrued during the taxable year.

(2) Personal interest. For purposes of this subsection, the term "personal interest" means any interest allowable as a deduction under this chapter other than--

(A) interest paid or accrued on indebtedness properly allocable to a trade or business (other than the trade or business of performing services as an employee),

(B) any investment interest (within the meaning of subsection (d)),

(C) any interest which is taken into account under section 469 in computing income or loss from a passive activity of the taxpayer,

(D) any qualified residence interest (within the meaning of paragraph (3)), and

(E) any interest payable under section 6601 on any unpaid portion of the tax imposed by section 2001 for the period during which an extension of time for payment of such

tax is in effect under section 6163 or 6166 or under section 6166A (as in effect before its repeal by the Economic Recovery Tax Act of 1981).

(3) Qualified residence interest. For purposes of this subsection--

(A) In general. The term "qualified residence interest" means any interest which is paid or accrued during the taxable year on--

(i) acquisition indebtedness with respect to any qualified residence of the taxpayer, or

(ii) home equity indebtedness with respect to any qualified residence of the taxpayer.

For purposes of the preceding sentence, the determination of whether any property is a qualified residence of the taxpayer shall be made as of the time the interest is accrued.

(B) Acquisition indebtedness.

(i) In general. The term "acquisition indebtedness" means any indebtedness which--

(I) is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and

(II) is secured by such residence.

Such term also includes any indebtedness secured by such residence resulting from the refinancing of indebtedness meeting the requirements of the preceding sentence (or this sentence); but only to the extent the amount of the indebtedness resulting from such refinancing does not exceed the amount of the refinanced indebtedness.

(ii) $1,000,000 Limitation. The aggregate amount treated as acquisition indebtedness for any period shall not exceed $ 1,000,000 ($ 500,000 in the case of a married individual filing a separate return).

(C) Home equity indebtedness.

(i) In general. The term "home equity indebtedness" means any indebtedness (other than acquisition indebtedness) secured by a qualified residence to the extent the aggregate amount of such indebtedness does not exceed--

(I) the fair market value of such qualified residence, reduced by

(II) the amount of acquisition indebtedness with respect to such residence.

(ii) Limitation. The aggregate amount treated as home equity indebtedness for any period shall not exceed $ 100,000 ($ 50,000 in the case of a separate return by a married individual).

(D) Treatment of indebtedness incurred on or before October 13, 1987.

(i) In general. In the case of any pre-October 13, 1987, indebtedness--

(I) such indebtedness shall be treated as acquisition indebtedness, and

(II) the limitation of subparagraph (B)(ii) shall not apply.

(ii) Reduction in $ 1,000,000 limitation. The limitation of subparagraph (B)(ii) shall be reduced (but not below zero) by the aggregate amount of outstanding pre-October 13, 1987, indebtedness.

(iii) Pre-October 13, 1987, indebtedness. The term "pre-October 13, 1987, indebtedness" means--

(I) any indebtedness which was incurred on or before October 13, 1987, and which was secured by a qualified residence on October 13, 1987, and at all times thereafter before the interest is paid or accrued, or

(II) any indebtedness which is secured by the qualified residence and was incurred after October 13, 1987, to refinance indebtedness described in subclause (I) (or refinanced indebtedness meeting the requirements of this subclause) to the extent (immediately after the refinancing) the principal amount of the indebtedness resulting from the refinancing does not exceed the principal amount of the refinanced indebtedness (immediately before the refinancing).

(iv) Limitation on period of refinancing. Subclause (II) of clause (iii) shall not apply to any indebtedness after--

(I) the expiration of the term of the indebtedness described in clause (iii)(I), or

(II) if the principal of the indebtedness described in clause (iii)(I) is not amortized over its term, the expiration of the term of the 1st refinancing of such indebtedness (or if earlier, the date which is 30 years after the date of such 1st refinancing).

(4) Other definitions and special rules. For purposes of this subsection--

(A) Qualified residence.

(i) In general. The term "qualified residence" means--

(I) the principal residence (within the meaning of section 1034) of the taxpayer, and

(II) 1 other residence of the taxpayer which is selected by the taxpayer for purposes of this subsection for the taxable year and which is used by the taxpayer as a residence (within the meaning of section 280A(d)(1)).

(ii) Married individuals filing separate returns. If a married couple does not file a joint return for the taxable year--

(I) such couple shall be treated as 1 taxpayer for purposes of clause (i), and

(II) each individual shall be entitled to take into account 1 residence unless both individuals consent in writing to 1 individual taking into account the principal residence and 1 other residence.

(iii) Residence not rented. For purposes of clause (i)(II), notwithstanding section 280A(d)(1), if the taxpayer does not rent a dwelling unit at any time during a taxable year, such unit may be treated as a residence for such taxable year.

(B) Special rule for cooperative housing corporations. Any indebtedness secured by stock held by the taxpayer as a tenant-stockholder (as defined in section 216) in a cooperative housing corporation (as so defined) shall be treated as secured by the house or apartment which the taxpayer is entitled to occupy as such a tenant-stockholder. If stock described in the preceding sentence may not be used to secure indebtedness, indebtedness shall be treated as so secured if the taxpayer establishes to the satisfaction of the Secretary that such indebtedness was incurred to acquire such stock.

(C) Unenforceable security interests. Indebtedness shall not fail to be treated as secured by any property solely because, under any applicable State or local homestead or other debtor protection law in effect on August 16, 1986, the security interest is ineffective or the enforceability of the security interest is restricted.

(D) Special rules for estates and trusts. For purposes of determining whether any interest paid or accrued by an estate or trust is qualified residence interest, any residence held by such estate or trust shall be treated as a qualified residence of such estate or trust if such estate or trust establishes that such residence is a qualified residence of a beneficiary who has a present interest in such estate or trust or an interest in the residuary of such estate or trust.

(5) Phase-in of limitation. In the case of any taxable year beginning in calendar years 1987 through 1990, the amount of interest with respect to which a deduction is disallowed under this subsection shall be equal to the applicable percentage (within the meaning of subsection (d)(6)(B)) of the amount which (but for this paragraph) would have been so disallowed.

(i) Applicable high yield discount obligation.

(1) In general. For purposes of this section, the term "applicable high yield discount obligation" means any debt instrument if--

(A) the maturity date of such instrument is more than 5 years from the date of issue,

(B) the yield to maturity on such instrument equals or exceeds the sum of--

(i) the applicable Federal rate in effect under section 1274(d) for the calendar month in which the obligation is issued, plus

(ii) 5 percentage points, and

(C) such instrument has significant original issue discount.

For purposes of subparagraph (B)(i), the Secretary may by regulation permit a rate to be used with respect to any debt instrument which is higher than the applicable Federal rate if the taxpayer establishes to the satisfaction of the Secretary that such higher rate is based on the same principles as the applicable Federal rate and is appropriate for the term of the instrument.

(2) **Significant original issue discount**. For purposes of paragraph (1)(C), a debt instrument shall be treated as having significant original issue discount if--

(A) the aggregate amount which would be includible in gross income with respect to such instrument for periods before the close of any accrual period (as defined in section 1272(a)(5)) ending after the date 5 years after the date of issue, exceeds--

(B) the sum of--

(i) the aggregate amount of interest to be paid under the instrument before the close of such accrual period, and

(ii) the product of the issue price of such instrument (as defined in sections 1273(b) and 1274(a)) and its yield to maturity.

(3) Special rules. For purposes of determining whether a debt instrument is an applicable high yield discount obligation--

(A) any payment under the instrument shall be assumed to be made on the last day permitted under the instrument, and

(B) any payment to be made in the form of another obligation of the issuer (or a related person within the meaning of section 453(f)(1)) shall be assumed to be made when such obligation is required to be paid in cash or in property other than such obligation.

Except for purposes of paragraph (1)(B), any reference to an obligation in subparagraph (B) of this paragraph shall be treated as including a reference to stock.

(4) Debt instrument. For purposes of this subsection, the term "debt instrument" means any instrument which is a debt instrument as defined in section 1275(a).

(5) Regulations. The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this subsection and subsection (e)(5), including--

(A) regulations providing for modifications to the provisions of this subsection and subsection (e)(5) in the case of varying rates of interest, put or call options, indefinite maturities, contingent payments, assumptions of debt instruments, conversion rights, or other circumstances where such modifications are appropriate to carry out the purposes of this subsection and subsection (e)(5), and

(B) regulations to prevent avoidance of the purposes of this subsection and subsection (e)(5) through the use of issuers other than C corporations, agreements to borrow

amounts due under the debt instrument, or other arrangements.

(j) Limitation on deduction for interest on certain indebtedness [Caution: For provisions applicable to interest paid or accrued in taxable years beginning on or before 12/31/93, see note below with respect to amendments made by P.L. 103-66, Sec. 13228(a)--(c)].

(1) Limitation.

(A) In general. If this subsection applies to any corporation for any taxable year, no deduction shall be allowed under this chapter for disqualified interest paid or accrued by such corporation during such taxable year. The amount disallowed under the preceding sentence shall not exceed the corporation's excess interest expense for the taxable year.

(B) Disallowed amount carried to succeeding taxable year. Any amount disallowed under subparagraph (A) for any taxable year shall be treated as disqualified interest paid or accrued in the succeeding taxable year.

(2) Corporations to which subsection applies.

(A) In general. This subsection shall apply to any corporation for any taxable year if--

(i) such corporation has excess interest expense for such taxable year, and

(ii) the ratio of debt to equity of such corporation as of the close of such taxable year (or on any other day during the taxable year as the Secretary may by regulations prescribe) exceeds 1.5 to 1.

(B) Excess interest expense.

(i) In general. For purposes of this subsection, the term "excess interest expense" means the excess (if any) of--

(I) the corporation's net interest expense, over

(II) the sum of 50 percent of the adjusted taxable income of the corporation plus any excess limitation carryforward under clause (ii).

(ii) Excess limitation carryforward. If a corporation has an excess limitation for any taxable year, the amount of such excess limitation shall be an excess limitation carryforward to the 1st succeeding taxable year and to the 2nd and 3rd succeeding taxable years to the extent not previously taken into account under this clause. The amount of such a carryforward taken into account for any such succeeding taxable year shall not exceed the excess interest expense for such succeeding taxable year (determined without regard to the carryforward from the taxable year of such excess limitation).

(iii) Excess limitation. For purposes of clause (i), the term "excess limitation" means the excess (if any) of--

(I) 50 percent of the adjusted taxable income of the corporation, over

(II) the corporation's net interest expense.

(C) Ratio of debt to equity. For purposes of this paragraph, the term "ratio of debt to equity" means the ratio which the total indebtedness of the corporation bears to the sum of its money and all other assets reduced (but not below zero) by such total indebtedness. For purposes of the preceding sentence--

(i) the amount taken into account with respect to any asset shall be the adjusted basis thereof for purposes of determining gain,

(ii) the amount taken into account with respect to any indebtedness with original issue discount shall be its issue price plus the portion of the original issue discount previously accrued as determined under the rules of section 1272 (determined without regard to subsection (a)(7) or (b)(4) thereof), and

(iii) there shall be such other adjustments as the Secretary may by regulations prescribe.

(3) Disqualified interest. For purposes of this subsection, the term "disqualified interest" means--

(A) any interest paid or accrued by the taxpayer (directly or indirectly) to a related person if no tax is imposed by this subtitle with respect to such interest, and

(B) any interest paid or accrued by the taxpayer with respect to any indebtedness to a person who is not a related person if--

(i) there is a disqualified guarantee of such indebtedness, and

(ii) no gross basis tax is imposed by this subtitle with respect to such interest.

(4) Related person. For purposes of this subsection--

(A) In general. Except as provided in subparagraph (B), the term "related person" means any person who is related (within the meaning of section 267(b) or 707(b)(1)) to the taxpayer.

(B) Special rule for certain partnerships.

(i) In general. Any interest paid or accrued to a partnership which (without regard to this subparagraph) is a related person shall not be treated as paid or accrued to a related person if less than 10 percent of the profits and capital interests in such partnership are held by persons with respect to whom no tax is imposed by this subtitle on such interest. The preceding sentence shall not apply to any interest allocable to any partner in such partnership who is a related person to the taxpayer.

(ii) Special rule where treaty reduction. If any treaty between the United States and any foreign country reduces the rate of tax imposed by this subtitle on a partner's share of any interest paid or accrued to a partnership, such partner's interests in such partnership shall, for purposes of clause (i), be treated as held in part by a tax-exempt person and in part by a taxable person under rules similar to the rules of paragraph (5)(B).

(5) Special rules for determining whether interest is subject to tax.

(A) Treatment of pass-thru entities. In the case of any interest paid or accrued to a partnership, the determination of whether any tax is imposed by this subtitle on such interest shall be made at the partner level. Rules similar to the rules of the preceding sentence shall apply in the case of any pass-thru entity other than a partnership and in the case of tiered partnerships and other entities.

(B) Interest treated as tax-exempt to extent of treaty reduction. If any treaty between the United States and any foreign country reduces the rate of tax imposed by this subtitle on any interest paid or accrued by the taxpayer, such interest shall be treated as interest on which no tax is imposed by this subtitle to the extent of the same proportion of such interest as--

(i) the rate of tax imposed without regard to such treaty, reduced by the rate of tax imposed under the treaty, bears to

(ii) the rate of tax imposed without regard to the treaty.

(6) Other definitions and special rules. For purposes of this subsection--

(A) Adjusted taxable income. The term "adjusted taxable income" means the taxable income of the taxpayer--

(i) computed without regard to--

(I) any deduction allowable under this chapter for the net interest expense,

(II) the amount of any net operating loss deduction under section 172, and

(III) any deduction allowable for depreciation, amortization, or depletion, and

(ii) computed with such other adjustments as the Secretary may by regulations prescribe.

(B) Net interest expense. The term "net interest expense" means the excess (if any) of--

(i) the interest paid or accrued by the taxpayer during the taxable year, over

(ii) the amount of interest includible in the gross income of such taxpayer for such taxable year.

The Secretary may by regulations provide for adjustments in determining the amount of net interest expense.

(C) Treatment of affiliated group. All members of the same affiliated group (within the meaning of section 1504(a)) shall be treated as 1 taxpayer.

(D) Disqualified guarantee.

(i) In general. Except as provided in clause (ii), the term "disqualified guarantee" means any guarantee by a related person which is--

(I) an organization exempt from taxation under this subtitle, or

(II) a foreign person.

(ii) Exceptions. The term "disqualified guarantee" shall not include a guarantee--

(I) in any circumstances identified by the Secretary by regulation, where the interest on the indebtedness would have been subject to a net basis tax if the interest had been paid to the guarantor, or

(II) if the taxpayer owns a controlling interest in the guarantor.

For purposes of subclause (II), except as provided in regulations, the term "a controlling interest" means direct or indirect ownership of at least 80 percent of the total voting power and value of all classes of stock of a corporation, or 80 percent of the profit and capital interests in any other entity. For purposes of the preceding sentence, the rules of paragraphs (1) and (5) of section 267(c) shall apply; except that such rules shall also apply to interest in entities other than corporations.

(iii) Guarantee. Except as provided in regulations, the term "guarantee" includes any arrangement under which a person (directly or indirectly through an entity or otherwise) assures, on a conditional or unconditional basis, the payment of another person's obligation under any indebtedness.

(E) Gross basis and net basis taxation.

(i) Gross basis tax. The term "gross basis tax" means any tax imposed by this subtitle which is determined by reference to the gross amount of any item of income without any reduction for any deduction allowed by this subtitle.

(ii) Net basis tax. The term "net basis tax" means any tax imposed by this subtitle which is not a gross basis tax.

(7) Regulations. The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this subsection, including--

(A) such regulations as may be appropriate to prevent the avoidance of the purposes of this subsection,

(B) regulations providing such adjustments in the case of corporations which are members of an affiliated group as may be appropriate to carry out the purposes of this subsection, and

(C) regulations for the coordination of this subsection with section 884.

(k) Cross references.

(1) For disallowance of certain amounts paid in connection with insurance, endowment, or annuity contracts, see section 264.

(2) For disallowance of deduction for interest relating to tax-exempt income, see section 265(a)(2).

(3) For disallowance of deduction for carrying charges chargeable to capital account, see section 266.

(4) For disallowance of interest with respect to transactions between related taxpayers, see section 267.

(5) For treatment of redeemable ground rents and real property held subject to liabilities under redeemable ground rents, see section 1055.

I.R.C. § 165 (1993)

§ 165. Losses.

(a) General rule. There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) Amount of deduction. For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) Limitation on losses of individuals. In the case of an individual, the deduction under subsection (a) shall be limited to

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

(3) except as provided in subsection (h), losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.

(d) Wagering losses. Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions.

(e) Theft losses. For purposes of subsection (a), any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss.

(f) Capital losses. Losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212.

(g) Worthless securities.

(1) General rule. If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

(2) Security defined. For purposes of this subsection, the term "security" means--

(A) a share of stock in a corporation;

(B) a right to subscribe for, or to receive, a share of stock in a corporation; or

(C) a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

(3) Securities in affiliated corporation. or purposes of paragraph (1), any security in a corporation affiliated with a taxpayer which is a domestic corporation shall not be treated as a capital asset. For purposes of the preceding sentence, a corporation shall be treated as affiliated with the taxpayer only if--

(A) stock possessing at least 80 percent of the voting power of all classes of its stock and at least 80 percent of each class of its nonvoting stock is owned directly by the taxpayer, and

(B) more than 90 percent of the aggregate of its gross receipts for all taxable years has been from sources other than

royalties, rents (except rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities.

In computing gross receipts for purposes of the preceding sentence, gross receipts from sales or exchanges of stocks and securities shall be taken into account only to the extent of gains therefrom. As used in subparagraph (A), the term "stock" does not include nonvoting stock which is limited and preferred as to dividends.

(h) Treatment of casualty gains and losses.

(1) $100 limitation per casualty. Any loss of an individual described in subsection (c)(3) shall be allowed only to the extent that the amount of the loss to such individual arising from each casualty, or from each theft, exceeds $ 100.

(2) Net casualty loss allowed only to the extent it exceeds 10 percent of adjusted gross income.

(A) In general. If the personal casualty losses for any taxable year exceed the personal casualty gains for such taxable year, such losses shall be allowed for the taxable year only to the extent of the sum of--

(i) the amount of the personal casualty gains for the taxable year, plus

(ii) so much of such excess as exceeds 10 percent of the adjusted gross income of the individual.

(B) Special rule where personal casualty gains exceed personal casualty losses. If the personal casualty

gains for any taxable year exceed the personal casualty losses for such taxable year--

(i) all such gains shall be treated as gains from sales or exchanges of capital assets, and

(ii) all such losses shall be treated as losses from sales or exchanges of capital assets.

(3) Definitions of personal casualty gain and personal casualty loss. For purposes of this subsection--

(A) Personal casualty gain. The term "personal casualty gain" means the recognized gain from any involuntary conversion of property which is described in subsection (c)(3) arising from fire, storm, shipwreck, or other casualty, or from theft.

(B) Personal casualty loss. The term "personal casualty loss" means any loss described in subsection (c)(3). For purposes of paragraph (2), the amount of any personal casualty loss shall be determined after the application of paragraph (1).

(4) Special rules.

(A) Personal casualty losses allowable in computing adjusted gross income to the extent of personal casualty gains. In any case to which paragraph (2)(A) applies, the deduction for personal casualty losses for any taxable year shall be treated as a deduction allowable in computing adjusted gross income to the extent such losses do not exceed the personal casualty gains for the taxable year.

(B) Joint returns. For purposes of this subsection, a husband and wife making a joint return for the taxable year shall be treated as 1 individual.

(C) Determination of adjusted gross income in case of estates and trusts. For purposes of paragraph (2), the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that the deductions for costs paid or incurred in connection with the administration of the estate or trust shall be treated as allowable in arriving at adjusted gross income.

(D) Coordination with estate tax. No loss described in subsection (c)(3) shall be allowed if, at the time of filing the return, such loss has been claimed for estate tax purposes in the estate tax return.

(E) Claim required to be filed in certain cases. Any loss of an individual described in subsection (c)(3) to the extent covered by insurance shall be taken into account under this section only if the individual files a timely insurance claim with respect to such loss.

(i) Disaster losses.

(1) Election to take deduction for preceding year. Notwithstanding the provisions of subsection (a), any loss attributable to a disaster occurring in an area subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Disaster Relief and Emergency Assistance Act may, at the election of the taxpayer, be taken into account for the taxable year immediately preceding the taxable year in which the disaster occurred.

(2) Year of loss. If an election is made under this subsection, the casualty resulting in the loss shall be treated for purposes of this title as having occurred in the taxable year for which the deduction is claimed.

(3) Amount of loss. The amount of the loss taken into account in the preceding taxable year by reason of paragraph

(1) shall not exceed the uncompensated amount determined on the basis of the facts existing at the date the taxpayer claims the loss.

(j) Denial of deduction for losses on certain obligations not in registered form.

(1) In general. Nothing in subsection (a) or in any other provision of law shall be construed to provide a deduction for any loss sustained on any registration-required obligation unless such obligation is in registered form (or the issuance of such obligation was subject to tax under section 4701).

(2) Definitions. For purposes of this subsection--

(A) Registration-required obligation. The term "registration-required obligation" has the meaning given to such term by section 163(f)(2) except that clause (iv) of subparagraph (A), and subparagraph (B), of such section shall not apply.

(B) Registered form. The term "registered form" has the same meaning as when used in section 163(f).

(3) Exceptions. The Secretary may, by regulations, provide that this subsection and section 1287 shall not apply with respect to obligations held by any person if--

(A) such person holds such obligations in connection with a trade or business outside the United States,

(B) such person holds such obligations as a broker dealer (registered under Federal or State law) for sale to customers in the ordinary course of his trade or business,

(C) such person complies with reporting requirements with respect to ownership, transfers, and payments as the Secretary may require, or

(D) such person promptly surrenders the obligation to the issuer for the issuance of a new obligation in registered form, but only if such obligations are held under arrangements provided in regulations or otherwise which are designed to assure that such obligations are not delivered to any United States person other than a person described in subparagraph (A), (B), or (C).

(k) Treatment as disaster loss where taxpayer ordered to demolish or relocate residence in disaster area because of disaster. In the case of a taxpayer whose residence is located in an area which has been determined by the President of the United States to warrant assistance by the Federal Government under the Disaster Relief and Emergency Assistance Act, if--

(1) not later than the 120th day after the date of such determination, the taxpayer is ordered, by the government of the State or any political subdivision thereof in which such residence is located, to demolish or relocate such residence, and

(2) the residence has been rendered unsafe for use as a residence by reason of the disaster,

any loss attributable to such disaster shall be treated as a loss which arises from a casualty and which is described in subsection (i).

(l) Treatment of certain losses in insolvent financial institutions.

(1) In general. If--

(A) as of the close of the taxable year, it can reasonably be estimated that there is a loss on a qualified individual's deposit in a qualified financial institution, and

(B) such loss is on account of the bankruptcy or insolvency of such institution,

then the taxpayer may elect to treat the amount so estimated as a loss described in subsection (c)(3) incurred during the taxable year.

(2) Qualified individual defined. For purposes of this subsection, the term "qualified individual" means any individual, except an individual--

(A) who owns at least 1 percent in value of the outstanding stock of the qualified financial institution,

(B) who is an officer of the qualified financial institution,

(C) who is a sibling (whether by the whole or half blood), spouse, aunt, uncle, nephew, niece, ancestor, or lineal descendant of an individual described in subparagraph (A) or (B), or

(D) who otherwise is a related person (as defined in section 267(b)) with respect to an individual described in subparagraph (A) or (B).

(3) Qualified financial institution. For purposes of this subsection, the term "qualified financial institution" means--

(A) any bank (as defined in section 581),

(B) any institution described in section 591,

(C) any credit union the deposits or accounts in which are insured under Federal or State law or are protected or guaranteed under State law, or

(D) any similar institution chartered and supervised under Federal or State law.

(4) Deposit. For purposes of this subsection, the term "deposit" means any deposit, withdrawable account, or withdrawable or repurchasable share.

(5) Election to treat as ordinary loss.

(A) In general. In lieu of any election under paragraph (1), the taxpayer may elect to treat the amount referred to in paragraph (1) for the taxable year as an ordinary loss described in subsection (c)(2) incurred during the taxable year.

(B) Limitations.

(i) Deposit may not be federally insured. No election may be made under subparagraph (A) with respect to any loss on a deposit in a qualified financial institution if part or all of such deposit is insured under Federal law.

(ii) Dollar limitation. With respect to each financial institution, the aggregate amount of losses attributable to deposits in such financial institution to which an election under subparagraph (A) may be made by the taxpayer for any taxable year shall not exceed $ 20,000 ($ 10,000 in the case of a separate return by a married individual). The limitation of the preceding sentence shall be reduced by the amount of any insurance proceeds under any State law which can reasonably be expected to be received with respect to losses on deposits in such institution.

(6) Election. Any election by the taxpayer under this subsection for any taxable year--

(A) shall apply to all losses for such taxable year of the taxpayer on deposits in the institution with respect to which such election was made, and

(B) may be revoked only with the consent of the Secretary.

(7) Coordination with section 166. Section 166 shall not apply to any loss to which an election under this subsection applies.

(m) Cross references.

(1) For special rule for banks with respect to worthless securities, see section 582.

(2) For disallowance of deduction for worthlessness of securities to which subsection (g)(2)(C) applies, if issued by a political party or similar organization, see section 271.

(3) For special rule for losses on stock in a small business investment company, see section 1242.

(4) For special rule for losses of a small business investment company, see section 1243.

(5) For special rule for losses on small business stock, see section 1244.

I.R.C. § 183 (1993)

§ 183. Activities not engaged in for profit.

(a) General rule. In the case of an activity engaged in by an individual or an S corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.

(b) Deductions allowable. In the case of an activity not engaged in for profit to which subsection (a) applies, there shall be allowed--

(1) the deductions which would be allowable under this chapter for the taxable year without regard to whether or not such activity is engaged in for profit, and

(2) a deduction equal to the amount of the deductions which would be allowable under this chapter for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).

(c) Activity not engaged in for profit defined. For purposes of this section, the term "activity not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212.

(d) Presumption. If the gross income derived from an activity for 3 or more of the taxable years in the period of 5 consecutive taxable years which ends with the taxable year exceeds the deductions attributable to such activity (determined without regard to whether or not such activity is engaged in for profit), then, unless the Secretary establishes to the contrary, such activity shall be presumed for purposes of

this chapter for such taxable year to be an activity engaged in for profit. In the case of an activity which consists in major part of the breeding, training, showing, or racing of horses, the preceding sentence shall be applied by substituting "2" for "3" and "7" for "5".

(e) Special rule.

(1) In general. A determination as to whether the presumption provided by subsection (d) applies with respect to any activity shall, if the taxpayer so elects, not be made before the close of the fourth taxable year (sixth taxable year, in the case of an activity described in the last sentence of such subsection) following the taxable year in which the taxpayer first engages in the activity. For purposes of the preceding sentence, a taxpayer shall be treated as not having engaged in an activity during any taxable year beginning before January 1, 1970.

(2) Initial period. If the taxpayer makes an election under paragraph (1), the presumption provided by subsection (d) shall apply to each taxable year in the 5-taxable year (or 7-taxable year) period beginning with the taxable year in which the taxpayer first engages in the activity, if the gross income derived from the activity for 3 (or 2 if applicable) or more of the taxable years in such period exceeds the deductions attributable to the activity (determined without regard to whether or not the activity is engaged in for profit).

(3) Election. An election under paragraph (1) shall be made at such time and manner, and subject to such terms and conditions, as the Secretary may prescribe.

(4) Time for assessing deficiency attributable to activity. If a taxpayer makes an election under paragraph (1) with respect to an activity, the statutory period for the assessment of any deficiency attributable to such activity shall

not expire before the expiration of 2 years after the date prescribed by law (determined without extensions) for filing the return of tax under chapter 1 for the last taxable year in the period of 5 taxable years (or 7 taxable years) to which the election relates. Such deficiency may be assessed notwithstanding the provisions of any law or rule of law which would otherwise prevent such an assessment.

I.R.C. § 195 (1993)

§ 195. Start-up expenditures.

(a) Capitalization of expenditures. Except as otherwise provided in this section, no deduction shall be allowed for start-up expenditures.

(b) Election to amortize.

(1) In general. Start-up expenditures may, at the election of the taxpayer, be treated as deferred expenses. Such deferred expenses shall be allowed as a deduction prorated equally over such period of not less than 60 months as may be selected by the taxpayer (beginning with the month in which the active trade or business begins).

(2) Dispositions before close of amortization period. In any case in which a trade or business is completely disposed of by the taxpayer before the end of the period to which paragraph (1) applies, any deferred expenses attributable to such trade or business which were not allowed as a deduction by reason of this section may be deducted to the extent allowable under section 165.

(c) Definitions. For purposes of this section--

(1) Start-up expenditures. The term "start-up expenditure" means any amount--

(A) paid or incurred in connection with--

(i) investigating the creation or acquisition of an active trade or business, or

(ii) creating an active trade or business, or

(iii) any activity engaged in for profit and for the production of income before the day on which the active trade

or business begins, in anticipation of such activity becoming an active trade or business, and

(B) which, if paid or incurred in connection with the operation of an existing active trade or business (in the same field as the trade or business referred to in subparagraph (A)), would be allowable as a deduction for the taxable year in which paid or incurred.

The term "start-up expenditure" does not include any amount with respect to which a deduction is allowable under section 163(a), 164, or 174.

(2) Beginning of trade or business.

(A) In general. Except as provided in subparagraph (B), the determination of when an active trade or business begins shall be made in accordance with such regulations as the Secretary may prescribe.

(B) Acquired trade or business. An acquired active trade or business shall be treated as beginning when the taxpayer acquires it.

(d) Election.

(1) Time for making election. An election under subsection (b) shall be made not later than the time prescribed by law for filing the return for the taxable year in which the trade or business begins (including extensions thereof).

(2) Scope of election. The period selected under subsection (b) shall be adhered to in computing taxable income for the taxable year for which the election is made and all subsequent taxable years.

I.R.C. § 212 (1993)

§ 212. Expenses for production of income.

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property held for the production of income; or

(3) in connection with the determination, collection, or refund of any tax.

I.R.C. § 263A (1993)

§ 263A. Capitalization and inclusion in inventory costs of certain expenses.

(a) Nondeductibility of certain direct and indirect costs.

(1) In general. In the case of any property to which this section applies, any costs described in paragraph (2)--

(A) in the case of property which is inventory in the hands of the taxpayer, shall be included in inventory costs, and

(B) in the case of any other property, shall be capitalized.

(2) Allocable costs. The costs described in this paragraph with respect to any property are--

(A) the direct costs of such property, and

(B) such property's proper share of those indirect costs (including taxes) part or all of which are allocable to such property.

Any cost which (but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph.

(b) Property to which section applies. Except as otherwise provided in this section, this section shall apply to--

(1) Property produced by taxpayer. Real or tangible personal property produced by the taxpayer.

(2) Property acquired for resale.

(A) In general. Real or personal property described in section 1221(1) which is acquired by the taxpayer for resale.

(B) Exception for taxpayer with gross receipts of $ 10,000,000 or less. Subparagraph (A) shall not apply to any personal property acquired during any taxable year by the taxpayer for resale if the average annual gross receipts of the taxpayer (or any predecessor) for the 3-taxable year period ending with the taxable year preceding such taxable year do not exceed $ 10,000,000.

(C) Aggregation rules, etc. For purposes of subparagraph (B), rules similar to the rules of paragraphs (2) and (3) of section 448(c) shall apply.

For purposes of paragraph (1), the term "tangible personal property" shall include a film, sound recording, video tape, book, or similar property.

(c) General exceptions.

(1) Personal use property. This section shall not apply to any property produced by the taxpayer for use by the taxpayer other than in a trade or business or an activity conducted for profit.

(2) Research and experimental expenditures. This section shall not apply to any amount allowable as a deduction under section 174.

(3) Certain development and other costs of oil and gas wells or other mineral property. This section shall not apply to any cost allowable as a deduction under section 263(c), 263(i), 291(b)(2), 616, or 617.

(4) Coordination with long-term contract rules. This section shall not apply to any property produced by the taxpayer pursuant to a long-term contract.

(5) Timber and certain ornamental trees. This section shall not apply to--

(A) trees raised, harvested, or grown by the taxpayer other than trees described in clause (ii) of subsection (e)(4)(B) (after application of the last sentence thereof), and

(B) any real property underlying such trees.

(6) Coordination with section 59(e). Paragraphs (2) and (3) shall apply to any amount allowable as a deduction under section 59(e) for qualified expenditures described in subparagraphs (B), (C), (D), and (E) of paragraph (2) thereof.

(d) Exception for farming businesses.

(1) Section not to apply to certain property.

(A) In general. This section shall not apply to any of the following which is produced by the taxpayer in a farming business:

(i) Any animal.

(ii) Any plant which has a preproductive period of 2 years or less.

(B) Exception for taxpayers required to use accrual method. Subparagraph (A) shall not apply to any corporation, partnership, or tax shelter required to use an accrual method of accounting under section 447 or 448(a)(3).

(2) Treatment of certain plants lost by reason of casualty.

(A) In general. If plants bearing an edible crop for human consumption were lost or damaged (while in the hands of the taxpayer) by reason of freezing temperatures, disease, drought, pests, or casualty, this section shall not apply to any costs of the taxpayer of replanting plants bearing the same type of crop (whether on the same parcel of land on which such lost or damaged plants were located or any other parcel of land of the same acreage in the United States).

(B) Special rule for person with minority interest who materially participates. Subparagraph (A) shall apply to amounts paid or incurred by a person (other than the taxpayer described in subparagraph (A)) if--

(i) the taxpayer described in subparagraph (A) has an equity interest of more than 50 percent in the plants described in subparagraph (A) at all times during the taxable year in which such amounts were paid or incurred, and

(ii) such other person holds any part of the remaining equity interest and materially participates in the planting, maintenance, cultivation, or development of the plants described in subparagraph (A) during the taxable year in which such amounts were paid or incurred.

The determination of whether an individual materially participates in any activity shall be made in a manner similar to the manner in which such determination is made under section 2032A(e)(6).

(3) Election to have this section not apply.

(A) In general. If a taxpayer makes an election under this paragraph, this section shall not apply to any plant produced in any farming business carried on by such taxpayer.

(B) Certain persons not eligible. No election may be made under this paragraph by a corporation, partnership, or tax shelter, if such corporation, partnership, or tax shelter is required to use an accrual method of accounting under section 447 or 448(a)(3).

(C) Special rule for citrus and almond growers. An election under this paragraph shall not apply with respect to any item which is attributable to the planting, cultivation, maintenance, or development of any citrus or almond grove (or part thereof) and which is incurred before the close of the 4th taxable year beginning with the taxable year in which the trees were planted. For purposes of the preceding sentence, the portion of a citrus or almond grove planted in 1 taxable year shall be treated separately from the portion of such grove planted in another taxable year.

(D) Election. Unless the Secretary otherwise consents, an election under this paragraph may be made only for the taxpayer's 1st taxable year which begins after December 31, 1986, and during which the taxpayer engages in a farming business. Any such election, once made, may be revoked only with the consent of the Secretary.

(e) Definitions and special rules for purposes of subsection (d).

(1) Recapture of expensed amounts on disposition.

(A) In general. In the case of any plant with respect to which amounts would have been capitalized under subsection (a) but for an election under subsection (d)(3)--

(i) such plant (if not otherwise section 1245 property) shall be treated as section 1245 property, and

(ii) for purposes of section 1245, the recapture amount shall be treated as a deduction allowed for depreciation with respect to such property.

(B) Recapture amount. For purposes of subparagraph (A), the term "recapture amount" means any amount allowable as a deduction to the taxpayer which, but for an election under subsection (d)(3), would have been capitalized with respect to the plant.

(2) Effects of election on depreciation.

(A) In general. If the taxpayer (or any related person) makes an election under subsection (d)(3), the provisions of section 168(g)(2) (relating to alternative depreciation) shall apply to all property of the taxpayer used predominantly in the farming business and placed in service in any taxable year during which any such election is in effect.

(B) Related person. For purposes of subparagraph (A), the term "related person" means--

(i) the taxpayer and members of the taxpayer's family,

(ii) any corporation (including an S corporation) if 50 percent or more (in value) of the stock of such corporation is owned (directly or through the application of section 318) by the taxpayer or members of the taxpayer's family,

(iii) a corporation and any other corporation which is a member of the same controlled group described in section 1563(a)(1), and

(iv) any partnership if 50 percent or more (in value) of the interests in such partnership is owned directly or

indirectly by the taxpayer or members of the taxpayer's family.

(C) Members of family. For purposes of this paragraph, the term "family" means the taxpayer, the spouse of the taxpayer, and any of their children who have not attained age 18 before the close of the taxable year.

(3) Preproductive period.

(A) In general. For purposes of this section, the term "preproductive period" means--

(i) in the case of a plant which will have more than 1 crop or yield, the period before the 1st marketable crop or yield from such plant, or

(ii) in the case of any other plant, the period before such plant is reasonably expected to be disposed of.

For purposes of this subparagraph, use by the taxpayer in a farming business of any supply produced in such business shall be treated as a disposition.

(B) Rule for determining period. In the case of a plant grown in commercial quantities in the United States, the preproductive period for such plant if grown in the United States shall be based on the nationwide weighted average preproductive period for such plant.

(4) Farming business. For purposes of this section--

(A) In general. The term "farming business" means the trade or business of farming.

(B) Certain trades and businesses included. The term "farming business" shall include the trade or business of-

(i) operating a nursery or sod farm, or

(ii) the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees.

For purposes of clause (ii), an evergreen tree which is more than 6 years old at the time severed from the roots shall not be treated as an ornamental tree.

(5) Certain inventory valuation methods permitted. The Secretary shall by regulations permit the taxpayer to use reasonable inventory valuation methods to compute the amount required to be capitalized under subsection (a) in the case of any plant.

(f) Special rules for allocation of interest to property produced by the taxpayer.

(1) Interest capitalized only in certain cases. Subsection (a) shall only apply to interest costs which are--

(A) paid or incurred during the production period, and

(B) allocable to property which is described in subsection (b)(1) and which has--

(i) a long useful life,

(ii) an estimated production period exceeding 2 years, or

(iii) an estimated production period exceeding 1 year and a cost exceeding $ 1,000,000.

(2) Allocation rules.

(A) In general. In determining the amount of interest required to be capitalized under subsection (a) with respect to any property--

(i) interest on any indebtedness directly attributable to production expenditures with respect to such property shall be assigned to such property, and

(ii) interest on any other indebtedness shall be assigned to such property to the extent that the taxpayer's interest costs could have been reduced if production expenditures (not attributable to indebtedness described in clause (i)) had not been incurred.

(B) Exception for qualified residence interest. Subparagraph (A) shall not apply to any qualified residence interest (within the meaning of section 163(h)).

(C) Special rule for flow-through entities. Except as provided in regulations, in the case of any flow-through entity, this paragraph shall be applied first at the entity level and then at the beneficiary level.

(3) Interest relating to property used to produce property. This subsection shall apply to any interest on indebtedness allocable (as determined under paragraph (2)) to property used to produce property to which this subsection applies to the extent such interest is allocable (as so determined) to the produced property.

(4) Definitions. For purposes of this subsection--

(A) Long useful life. Property has a long useful life if such property is--

(i) real property, or

(ii) property with a class life of 20 years or more (as determined under section 168).

(B) Production period. The term "production period" means, when used with respect to any property, the period--

(i) beginning on the date on which production of the property begins, and

(ii) ending on the date on which the property is ready to be placed in service or is ready to be held for sale.

(C) **Production expenditures**. The term "production expenditures" means the costs (whether or not incurred during the production period) required to be capitalized under subsection (a) with respect to the property.

(g) **Production**. For purposes of this section--

(1) **In general**. The term "produce" includes construct, build, install, manufacture, develop, or improve.

(2) **Treatment of property produced under contract for the taxpayer**. The taxpayer shall be treated as producing any property produced for the taxpayer under a contract with the taxpayer; except that only costs paid or incurred by the taxpayer (whether under such contract or otherwise) shall be taken into account in applying subsection (a) to the taxpayer.

(h) **Exemption for free lance authors, photographers, and artists**.

(1) **In general**. Nothing in this section shall require the capitalization of any qualified creative expense.

(2) **Qualified creative expense**. For purposes of this subsection, the term "qualified creative expense" means any expense--

(A) which is paid or incurred by an individual in the trade or business of such individual (other than as an employee) of being a writer, photographer, or artist, and

(B) which, without regard to this section, would be allowable as a deduction for the taxable year.

Such term does not include any expense related to printing, photographic plates, motion picture films, video tapes, or similar items.

(3) Definitions. For purposes of this subsection--

(A) Writer. The term "writer" means any individual if the personal efforts of such individual create (or may reasonably be expected to create) a literary manuscript, musical composition (including any accompanying words), or dance score.

(B) Photographer. The term "photographer" means any individual if the personal efforts of such individual create (or may reasonably be expected to create) a photograph or photographic negative or transparency.

(C) Artist.--

(i) In general. The term "artist" means any individual if the personal efforts of such individual create (or may reasonably be expected to create) a picture, painting, sculpture, statue, etching, drawing, cartoon, graphic design, or original print edition.

(ii) Criteria. In determining whether any expense is paid or incurred in the trade or business of being an artist, the following criteria shall be taken into account:

(I) The originality and uniqueness of the item created (or to be created).

(II) The predominance of aesthetic value over utilitarian value of the item created (or to be created).

(D) Treatment of certain corporations.

(i) In general. If--

(I) substantially all of the stock of a corporation is owned by a qualified employee-owner and members of his family (as defined in section 267(c)(4)), and

(II) the principal activity of such corporation is performance of personal services directly related to the activities of the qualified employee-owner and such services are substantially performed by the qualified employee-owner,

this subsection shall apply to any expense of such corporation which directly relates to the activities of such employee-owner in the same manner as if such expense were incurred by such employee-owner.

(ii) Qualified employee-owner. For purposes of this subparagraph, the term "qualified employee-owner" means any individual who is an employee-owner of the corporation (as defined in section 269A(b)(2)) and who is a writer, photographer, or artist.

(i) Regulations. The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including--

(1) regulations to prevent the use of related parties, pass-thru entities, or intermediaries to avoid the application of this section, and

(2) regulations providing for simplified procedures for the application of this section in the case of property described in subsection (b)(2).

I.R.C. § 264 (1993)

§ 264. Certain amounts paid in connection with insurance contracts.

(a) General rule. No deduction shall be allowed for--

(1) Premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.

(2) Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract.

(3) Except as provided in subsection (c), any amount paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance, endowment, or annuity contract (other than a single premium contract or a contract treated as a single premium contract) pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract (either from the insurer or otherwise).

(4) Any interest paid or accrued on any indebtedness with respect to 1 or more life insurance policies owned by the taxpayer covering the life of any individual who--

(A) is an officer or employee of, or

(B) is financially interested in,

(C) any trade or business carried on by the taxpayer to the extent that the aggregate amount of such indebtedness with respect to policies covering such individual exceeds $ 50,000.

Paragraph (2) shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954. Paragraph (3) shall apply only in respect of contracts purchased after August 6, 1963. Paragraph (4) shall apply with respect to contracts purchased after June 20, 1986.

(b) Contracts treated as single premium contracts. For purposes of subsection (a)(2), a contract shall be treated as a single premium contract--

(1) if substantially all the premiums on the contract are paid within a period of 4 years from the date on which the contract is purchased, or

(2) if an amount is deposited after March 1, 1954, with the insurer for payment of a substantial number of future premiums on the contract.

(c) Exceptions. Subsection (a)(3) shall not apply to any amount paid or accrued by a person during a taxable year on indebtedness incurred or continued as part of a plan referred to in subsection (a)(3)--

(1) if no part of 4 of the annual premiums due during the 7-year period (beginning with the date the first premium on the contract to which such plan relates was paid) is paid under such plan by means of indebtedness,

(2) if the total of the amounts paid or accrued by such person during such taxable year for which (without regard to this paragraph) no deduction would be allowable by reason of subsection (a)(3) does not exceed $ 100,

(3) if such amount was paid or accrued on indebtedness incurred because of an unforeseen substantial loss of income or unforeseen substantial increase in his financial obligations, or

(4) if such indebtedness was incurred in connection with his trade or business.

For purposes of applying paragraph (1), if there is a substantial increase in the premiums on a contract, a new 7-year period described in such paragraph with respect to such contract shall commence on the date the first such increased premium is paid.

I.R.C. § 269 (1993)

§ 269. Acquisitions made to evade or avoid income tax.

(a) In general. If--

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation,

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

(b) Certain liquidations after qualified stock purchases.

(1) In general. If--

(A) there is a qualified stock purchase by a corporation of another corporation,

(B) an election is not made under section 338 with respect to such purchase,

(C) the acquired corporation is liquidated pursuant to a plan of liquidation adopted not more than 2 years after the acquisition date, and

(D) the principal purpose for such liquidation is the evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which the acquiring corporation would not otherwise enjoy,

then the Secretary may disallow such deduction, credit, or other allowance.

(2) **Meaning of terms.** For purposes of paragraph (1), the terms "qualified stock purchase" and "acquisition date" have the same respective meanings as when used in section 338.

(c) **Power of Secretary to allow deduction, etc., in part.** In any case to which subsection (a) or (b) applies the Secretary is authorized--

(1) to allow as a deduction, credit, or allowance any part of any amount disallowed by such subsection, if he determines that such allowance will not result in the evasion or avoidance of Federal income tax for which the acquisition was made; or

(2) to distribute, apportion, or allocate gross income, and distribute, apportion, or allocate the deductions, credits, or allowances the benefit of which was sought to be secured, between or among the corporations, or properties, or parts thereof, involved, and to allow such deductions, credits, or allowances so distributed, apportioned, or allocated, but to give effect to such allowance only to such extent as he determines will not result in the evasion or avoidance of Federal income tax for which the acquisition was made; or

(3) to exercise his powers in part under paragraph (1) and in part under paragraph (2).

I.R.C. § 357 (1993)

§ 357. Assumption of liability.

(a) General rule. Except as provided in subsections (b) and (c), if--

(1) the taxpayer receives property which would be permitted to be received under section 351 or 361 without the recognition of gain if it were the sole consideration, and

(2) as part of the consideration, another party to the exchange assumes a liability of the taxpayer, or acquires from the taxpayer property subject to a liability,

then such assumption or acquisition shall not be treated as money or other property, and shall not prevent the exchange from being within the provisions of section 351 or 361, as the case may be.

(b) Tax avoidance purpose.

(1) In general. If, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition described in subsection (a)--

(A) was a purpose to avoid Federal income tax on the exchange, or

(B) if not such purpose, was not a bona fide business purpose,

then such assumption or acquisition (in the total amount of the liability assumed or acquired pursuant to such exchange) shall, for purposes of section 351 or 361 (as the case may be),

be considered as money received by the taxpayer on the exchange.

(2) Burden of proof. In any suit or proceeding where the burden is on the taxpayer to prove such assumption or acquisition is not to be treated as money received by the taxpayer, such burden shall not be considered as sustained unless the taxpayer sustains such burden by the clear preponderance of the evidence.

(c) Liabilities in excess of basis.

(1) In general. In the case of an exchange--

(A) to which section 351 applies, or

(B) to which section 361 applies by reason of a plan of reorganization within the meaning of section 368(a)(1)(D),

if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

(2) Exceptions. Paragraph (1) shall not apply to any exchange--

(A) to which subsection (b)(1) of this section applies, or

(B) which is pursuant to a plan of reorganization within the meaning of section 368(a)(1)(G) where no former shareholder of the transferor corporation receives any consideration for his stock.

I.R.C. § 532 (1993)

§ 532. Corporations subject to accumulated earnings tax.

(a) General rule. The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

(b) Exceptions. The accumulated earnings tax imposed by section 531 shall not apply to--

(1) a personal holding company (as defined in section 542),

(2) a foreign personal holding company (as defined in section 552),

(3) a corporation exempt from tax under subchapter F (section 501 and following), or

(4) a passive foreign investment company (as defined in section 1296).

(c) Application determined without regard to number of shareholders. The application of this part to a corporation shall be determined without regard to the number of shareholders of such corporation.

I.R.C. § 845 (1993)

§ 845. Certain reinsurance agreements.

(a) Allocation in case of reinsurance agreement involving tax avoidance or evasion. In the case of 2 or more related persons (within the meaning of section 482) who are parties to a reinsurance agreement (or where one of the parties to a reinsurance agreement is, with respect to any contract covered by the agreement, in effect an agent of another party to such agreement or a conduit between related persons), the Secretary may--

(1) allocate between or among such persons income (whether investment income, premium, or otherwise), deductions, assets, reserves, credits, and other items related to such agreement,

(2) recharacterize any such items, or

(3) make any other adjustment,

if he determines that such allocation, recharacterization, or adjustment is necessary to reflect the proper source and character of the taxable income (or any item described in paragraph (1) relating to such taxable income) of each such person.

(b) Reinsurance contract having significant tax avoidance effect. If the Secretary determines that any reinsurance contract has a significant tax avoidance effect on any party to such contract, the Secretary may make proper adjustments with respect to such party to eliminate such tax avoidance effect (including treating such contract with respect to such party as terminated on December 31 of each year and reinstated on January 1 of the next year).

I.R.C. § 532 (1993)

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(b) Reinsurance contract having significant tax avoidance effect. If the Secretary determines that any reinsurance contract has a significant tax avoidance effect on any party to such contract, the Secretary may make proper adjustments with respect to such party to eliminate such tax avoidance effect (including treating such contract with respect to such party as terminated on December 31 of each year and reinstated on January 1 of the next year).